

Only persons who have actually paid taxes to the Department can file claims for credit. See 86 Ill. Adm. Code 130.1501. (This is a GIL.)

December 8, 1998

Dear Mr. Xxxxxx

This letter is in response to your letter dated May 5, 1998. We regret the delay in our response. The nature of your letter and the information you have provided require that we respond with a General Information Letter which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), enclosed.

In your letter, you have stated and made inquiry as follows:

I spoke to you some time ago about the Illinois Department of Revenue position regarding refunds of sales tax on bad debts where the sales tax was collected by retailers on installment sales, and the accounts were subsequently assigned to a third-party. You suggested that I request a letter ruling on this issue.

COMPANY (hereinafter referred to as 'COMPANY') respectfully requests a letter ruling as to whether it may take a credit on its Illinois sales and use tax returns for uncollectible accounts on installment sales that are written off as bad debts on its federal income tax return.

On March 13, 1997, COMPANY submitted a claim for refund on these uncollectible accounts, in the amount of \$153,566 (Enclosed as Exhibit 'A'). We have spoken with several people in the Department of Revenue, but have never been given definitive authorization to take these bad debts as a credit on our sales and use tax returns. I spoke with you some time ago about this situation, and you suggested that we request a letter ruling on this question from the Department's Legal Services Bureau.

A. Statement of Facts

COMPANY was incorporated in the State of New York, and has its administrative office located at ADDRESS. All outstanding common stock of COMPANY is owned by BUSINESS the common stock of which is in turn wholly owned by CORPORATION.

COMPANY provides financing services for private-label credit card programs involving vendors in many industries. COMPANY purchases consumer credit card accounts from vendors.

The transactions which give rise to the bad debt sales tax refund in this claim begin with the sale of tangible personal property or taxable services by a vendor to a purchaser on a credit basis. Immediately following this sale the vendor pays the sales tax on the entire amount of the sale to the Illinois Department of Revenue ('Department'). The vendor assigns the account to COMPANY. The purchase price COMPANY pays for the account includes the amount of sales tax paid by the vendor to the Department, which is then collected by COMPANY from the consumer.

The vendor assigns the account to COMPANY on a nonrecourse basis. COMPANY, therefore, has all of the rights, title and interest of the vendor in the account. When a consumer defaults, COMPANY will use various resources in attempting to collect the outstanding balance. In the event COMPANY is unsuccessful, the unrecovered portion of the debt becomes a worthless debt for federal income tax purposes. COMPANY deducts this amount on its federal income tax return.

COMPANY, as the assignee of different vendors, is entitled to recover the amount of sales tax paid on the portion of the assigned accounts that have become worthless debts.

Law and Analysis

1. Applicable Law and Regulations

Illinois imposes a retailer's occupation tax on persons engaged in the business of selling tangible personal property at retail. Ill. Rev. Stat. ch. 35, para. 120/2; Ill. Admin. Code tit. 86, § 130.101. The legal incidence of the tax is placed on the seller rather than on the purchaser. Ill. Admin. Code tit. 86, § 130.101. The basis of the tax is 'gross receipts' from sales of tangible personal property. Ill. Rev. Stat. ch. 35, para. 120/2-10. 'Gross receipts' means the total selling price and, in the case of charge and time sales, includes only the amounts received as payments from the purchaser. Ill. Rev. Stat. ch. 35, para. 120/1.

2. Analysis

COMPANY is due a refund of tax on these bad debts because it is registered as a retailer in Illinois, and because the assignment of these accounts should carry with it the right to obtain a refund on bad debts.

It has been Department administrative policy to allow a retailer filing a return for gross sales to take a bad debt deduction. The Department has expressed this policy through numerous private letter rulings. See, Private Letter Ruling No. 96-0020, Illinois Dep't of Revenue, January 16, 1996; See also, Private Letter Ruling 94-0250, Illinois Dep't of Revenue, July 1, 1994; Private Letter Ruling No. 92-0368, Illinois Dep't of Revenue, July 16, 1992. The Department reaffirmed this position in a July 1, 1994 General Information Letter. The General Information Letter provided that:

[A] retailer filing on the gross sales basis may take a bad debt deduction as an authorized deduction on the ST-1 return for the month in which that bad debt was written off for federal income tax purposes. General Information Letter, Ill. Dep't of Revenue, January 16, 1996.

COMPANY is a retailer registered with the Department of Revenue, although it is not the retailer that sold the items on the installment basis and collected Illinois sales tax on them. The price COMPANY paid to the initial retailers of these items reflected the amount of sales tax collected. COMPANY paid the initial retailers a price that included the amount of sales tax the retailers paid to the state.

Assignment Law

Under Illinois assignment law the assignee steps into the shoes of the assignor and assumes the same rights, title and interest possessed by the assignor. *Plumb v. Fluid Pump Service, Inc. et al.*, 124 F.3d 849, 864 (7th Cir. 1997), citing *Moutsopoulos v. American Mutual Ins. Co.*, 607 F.2d 1185, 1189 (7th Cir. 1979); see also *Ruva v. Mente*, 200 Ill. App.3d. 442, 557 N.E.2d 964 (Ill. App. 1990)(assignment transfers all of assignor's rights to assignee); *Collins Company v. Carboline Company et al.* 125 Ill.2d 498,837, 532 N.E.2d 834 (1988)(assignee of warrantee's rights under a warranty succeeds to all rights under the warranty, including right to sue for damages).

In the absence of a statute prohibiting it, the assignment of a right to an account should vest in the assignee all rights, and interest possessed by the assignor, including the right to pursue a tax refund.

There is no Illinois statute that bars the assignability of refund claims. In the absence of a statutory prohibition, the case law allows COMPANY to pursue tax refund claims arising out of its purchased installment sales contracts.

The Washington state Supreme Court recently decided a case whose facts are quite similar to those at issue here. In *Puget Sound National Bank v. Department of Revenue*, 868 P.2d 127 (Wash. 1994), the Washington Supreme Court held that a bank was entitled to a sales tax refund arising out of defaulted installment sale contracts assigned to it by automobile dealers. In the absence of a statutory prohibition against assignment, the court applied general principles of assignment law to determine that tax refund claims may be brought by an assignee.

The issue in *Puget Sound* was the statutory requirement that the person who makes the refund claim be the person making retail sales. In order for the bank to satisfy that requirement, the assignment of the installment contracts must satisfy the 'making sales at retail requirement.' The Court concluded that 'the status of the Bank includes the dealers' prior tax attribute of 'making sales at retail.' Since the assignment of the installment contracts carried with it the 'making sales at retail' requirement, the Bank is entitled to a sales tax refund ...' *Id.* at 132. The Court also concluded that 'an assignment carries with it the rights and liabilities identified in the assigned contract, but also all applicable statutory rights and liabilities. To hold otherwise would be contrary to the rule that the

assignee acquires whatever rights the assignor possessed prior to the assignment.'

Legislative Policy and Equitable Considerations

Under the terms of the contracts, COMPANY has no recourse against the original retailers from whom it purchased the contracts. These retailers did not write the accounts off their federal returns, therefore they would have no right to refund from the Department. Accordingly, a denial of the refund claim would create a windfall for the state.

In creating the right to obtain a refund of sales tax paid on bad debts the Illinois Legislature wanted to put retailers who operated on an accrual basis on an equal footing with retailers who operated on a cash basis. Because COMPANY is a registered retailer, and the assignee of the accounts on which the bad debts arose, it would be contrary to this legislative policy to deny it a refund claim because it was not the initial retailer in this transaction.

Free Transferability of Commercial Paper

Furthermore, to disallow COMPANY from taking a credit for these uncollectible accounts would result in a windfall to the state, and would pose a threat to the free transferability of commercial paper. These concerns were recognized by the *Puget Sound* Court.

An important policy reason for permitting the assignment of a tax refund claim under RCW 82.08.037 is to ensure that commercial paper continues to travel freely in the marketplace. If this court permits assignment of certain contractual or statutory rights, while prohibiting others, parties to an assignment will be unable to determine what rights and liabilities transfer in assignment.

Id. at 131

Ruling Requested

COMPANY respectfully requests the Department to rule on the following sales and use tax issue:

Whether COMPANY can take a credit on its Illinois Sales and Use Tax Returns for uncollectible accounts on installment sales for which Illinois sales tax has been paid and which have been written off COMPANY's federal income tax return.

We will contact you in the next several days to determine whether you require additional information or if we may otherwise be of assistance. In the event the Department is unable to provide a favorable response on any of the issues listed above, we would like the opportunity to meet with you to discuss further. We greatly appreciate your attention to this matter. I may be reached at ####.

As noted above, we cannot issue a binding determination in the context of a General Information Letter. However, we are providing the following general information about sales tax filing methods, installment and credit sales, the bad debt deduction, and claims for credit for your consideration.

Under Illinois law, retailers generally report and pay Retailers' Occupation Tax on gross receipts actually received on sales of tangible personal property. They are thus filing on the "gross receipts" basis. Retailers who report and pay Retailers' Occupation Tax up front on the total selling price of tangible personal property, even though all gross receipts have not yet been received from purchasers, are filing on the "gross sales" basis. As the gross receipts basis is statutorily established, it is the preferred method for filing sales tax returns. See 35 ILCS 120/3. However, the Department has promulgated a regulation, 86 Ill. Code 130.401, under which use of the gross sales method is permitted under certain conditions. In a further exercise of its administrative authority, the Department has authorized gross sales basis retailers to take bad debt deductions on their monthly sales tax returns when they are written off the taxpayers' books as uncollectible for federal income tax reporting purposes. Please note the gross sales basis for filing is authorized under the administrative regulation of the Department, it was not created by the Illinois General Assembly as you state in your letter. This means your legislative policy argument that the Illinois legislature wanted to put sales basis retailers on an equal footing with receipts basis retailers is misplaced because the only reporting method recognized in the Retailers' Occupation Tax Act is the receipts basis (35 ILCS 120/3).

The procedures found in Section 6 of the Retailers' Occupation Tax Act, 35 ILCS 120/6, regarding claims for credit are not available for bad debt situations. This is because Section 6 is limited to claims based on a "mistake of fact or error of law." A bad debt is not considered a mistake of fact or an error of law. Therefore, bad debts do not fall within the parameters of Section 6.

As a general proposition, companies that provide financing services may not claim a bad debt deduction for sales tax on retail transactions of tangible personal property where they were not the retailers. The Department has only authorized the bad debt deduction for gross sales basis retailers who have already paid the tax on sales, and having received no payment from customers for those sales, determine an amount as uncollectible for federal income tax purposes. Accordingly, the deduction is only allowable for these retailers when it is written off their books for federal income tax reporting purposes.

The question of whether transferred "paper" can carry with it the right to take a bad debt deduction must be analyzed in the context that only retailers who have actually paid taxes to the Department on their returns can take a bad debt deduction. In the case of installment sales, 86 Ill. Adm. Code 130.1960(c) provides that upon sales of the installment contracts or "paper" to a third party, Retailers' Occupation Tax becomes due based on the entire selling price to the purchasers of the tangible personal property, with credit allowed for any tax already remitted to the Department based on the receipts from the sale of the tangible personal property. The regulation also states that any difference between the selling price of the tangible personal property and the selling price of the installment contract or "paper" is a cost of doing business and therefore not deductible in computing Retailers' Occupation Tax liability. The crux of this is that when retailers of tangible personal property sell installment contracts/paper/accounts receivables, the Retailers' Occupation Tax liability is

payable at that time to the Department based on the retailers' entire selling price of the goods, rather than receipts received from sale of the paper. The duty to pay the Retailers' Occupation Tax is not passed on to the purchasers of the paper, it remains with the retailers who sold the tangible personal property at retail. This is the legal consequence of the fact that the Retailers' Occupation Tax is an occupation tax imposed upon retailers for the privilege of engaging in the occupation of retailing.

When retailers sell Section 130.1960(c) type "paper" to third parties, the Retailers' Occupation Tax liability is due on the part of the retailers at that point in time. Under the Retailers' Occupation Tax Act and the regulation, the Retailers' Occupation Tax liability is restricted to the original retailers, and is not transferred to purchasers of "paper." The tax liability, and the corresponding availability of the bad debt deduction, are established by the retailers' sales of tangible personal property to customers. Although the timing of the tax payment may mature upon sales of "paper," such as when companies provide financing for credit card transactions, these subsequent sales do not alter the condition that only retailers who have actually paid taxes to the Department on their returns can take a bad debt deduction.

I hope this information is helpful. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b).

Very truly yours,

Karl Betz
Associate Counsel

KB:msk
Encl.